

E-Memo

TO: INVESTORS/MEMBERS AND FRIENDS
FROM: Jon Bruss and Bob Ollech
Date: September 15, 2005
Subject: The Yield Curve, Growth and California

We're a bit late this month in writing our *E-Memo* because we spent most of last week in California. All three of the themes in the subject line: the yield curve, growth and California are relevant to us as investors in banks. How so?

Recently, financial media pundits have been wringing their hands over the impact of a flattening yield curve on bank earnings and, consequently, bank stock prices. We'd agree with these folks if the only banks we could invest in were the 50 largest banks in the US. Much has been written recently that the S & P 500 is unlikely to get on track any time soon because the S & P 500's largest sector is financials. That last assertion is at least arguable, but again, the big bank sector isn't our bailiwick.

What does it mean to banks when the yield curve flattens? Simply this: If short-term rates are virtually the same as longer-term rates, there is no financial benefit for bankers to "borrow short and lend long." That's something known as the "carry trade." Most of you've heard that the "carry trade" came to an end at the beginning of this year as the gap between long-term and short-term interest rates began to compress. So what do banks do then? If you listen to or read the pundits, they try to eek out a profit with a lesser spread between their cost of funds and the yield they can attain on their loan portfolios. That may cause what had been a net interest margin of say 4.00% to shrink to 3.75%. When you apply that to a \$1 billion loan portfolio, the lost revenue is \$2.5 million—a consequential hit to the bottom line. But what happens if during the year that same bank's loan portfolio actually grows by 10% (not an unrealistic scenario for an average small bank)? Well simply this: A \$40 million net interest margin (4.00% of \$1 billion) becomes \$41.25 million (3.75% of \$1.1 billion)—actually an improvement in revenue and in earnings, all other things being equal. We expect that you will argue that there will likely be more operating expense created by that loan growth and we'll grant you that, maybe. But look, our banks like the fictitious bank cited above may have a modest up tick in operating expense due to a 10% increase in loans, but we'd likely settle on \$250,000 to \$300,000 at most, if any at all. In addition, bank balance sheets are not static; there are other factors, such as the structure of the loan portfolio and the mix of deposits, which bank management can control to minimize the impact of the shape of the yield curve on margins.

We spend all of our time with micro and small cap banks and their executives for a whole host of reasons, not the least of which is that many of them have **a very simple formula for beating the flattening yield curve and that is growth**. The formula is as simple as that set forth in the paragraph above. So what does that have to do with California? Other than visiting with one of our investors in the Los Angeles area we spent two days calling on banks in which we have an investment and some in which we are considering investing. The latter part of the week was spent in a conference highlighting West Coast banks. We called on banks or heard from banks which have, over the twelve months ended June 30, 2005, averaged more than 26% loan growth, 19% deposit growth and a whopping 176% in earnings growth (median earnings growth was over 30%)!

We've been reading that bank margins and profits have been impacted this year by shrinking margins caused by the flattening of the yield curve. You've probably read the same. In fact we've seen some charts that purport to prove that as the yield curve flattens, financial stocks earnings actually decline. These charts compare the yield curve (usually represented by the spread between 10-year Treasury yield and the 90-day bill rate) with the earnings of the S & P 500 financial stocks. **Our experience has been quite the opposite**. Based, in part, on the results of our modest holdings in California, combined with holdings in the southeast and other pockets of growth across the nation, many well-run banks are achieving consistent

double-digit growth. Based on reported results for the second quarter of this year, the banks in our portfolio grew earnings per share by an average of 19% (excluding one bank with extraordinary one-time charges), loans at 17% and deposits at 16.8%, over the preceding 12 months.

Our experience is by no means conclusive, but what is indisputable is that **all banks are not the same**. There are significant differences between banks of similar size and there are clearly significant differences between large-cap banks as a group, and the micro- and small-cap banks in which we have invested. Those differences include:

- o simple and straightforward business models,
- o financial statements that are transparent and easy to understand,
- o the ability to quickly adapt to changing market conditions,
- o unpretentious senior management teams focused on:
 - hiring the best bank lenders and deposit gatherers in a market,
 - profitable growth,
 - risk management, and
 - building shareholder value (because they are significant shareholders themselves.)

California has certainly had its share of bad publicity over the years. It was (and is) the home of Silicon Valley and all the frenzied silliness of the "dot.com" nineties. It has witnessed several real estate booms, including, presumably, the present. It has endured recessions, power blackouts, urban riots, earthquakes of gargantuan proportions, mudslides, smog and Hollywood (the latter two may be inter-related). Add in stratospheric housing prices, massive traffic snarls and high taxes and you have to wonder why any sane person would choose to live there. Nonetheless, a recent Harris poll ranked California as the #1 place in the country where people want to live. California is home to nearly 15% of the nation's population and, if it were a separate country, would be the fifth largest economy in the world (ranking between Great Britain and France). Its economy is 13% of the US GDP (does this tell you something about France?). We believe that we need to have a stake in this state's growth, and we do. We can't help but be impressed by the California banks in which we have invested. The senior bankers managing them have decades of experience and have come from the ranks of chief financial officers, outside legal counsel and senior lenders. All of them have been through the "wars" of economic recessions and several real estate "boom and bust" cycles. As far as the latter is concerned, none of these bankers have a hankering to revisit those days. They have made sure that a downturn in California real estate values will not have an appreciable adverse impact on the banks they are managing. The profile of these banks and bankers does not differ significantly from the fast growing banks in which we have invested in Minnesota or Missouri or Massachusetts or Florida. To be sure the geography is different, but the strategy and philosophy are the same.

To sum it all up, well-managed growth can and does trump the shape of the yield curve. Well-managed balance sheet growth can provide double-digit earnings growth and there are more than a few small banks in vibrant markets around the country that can continue to grow assets and earnings at a pace far in excess of the large institutions that comprise the "financial sector." For the foreseeable future, our job is to continue to uncover those banks and to invest in them for the benefit of our clients, despite the periodic angst and hand wringing of the financial pundits who see the forest (the financial sector) and even the trees (all banks), but can't differentiate between a prized oak sapling (a small, but growing bank) and all the rest.

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